■ GM'S FUTURE • THE MARKET IS SAFER THAN YOU THINK • WARREN BUFFETT'S GOOFS ■

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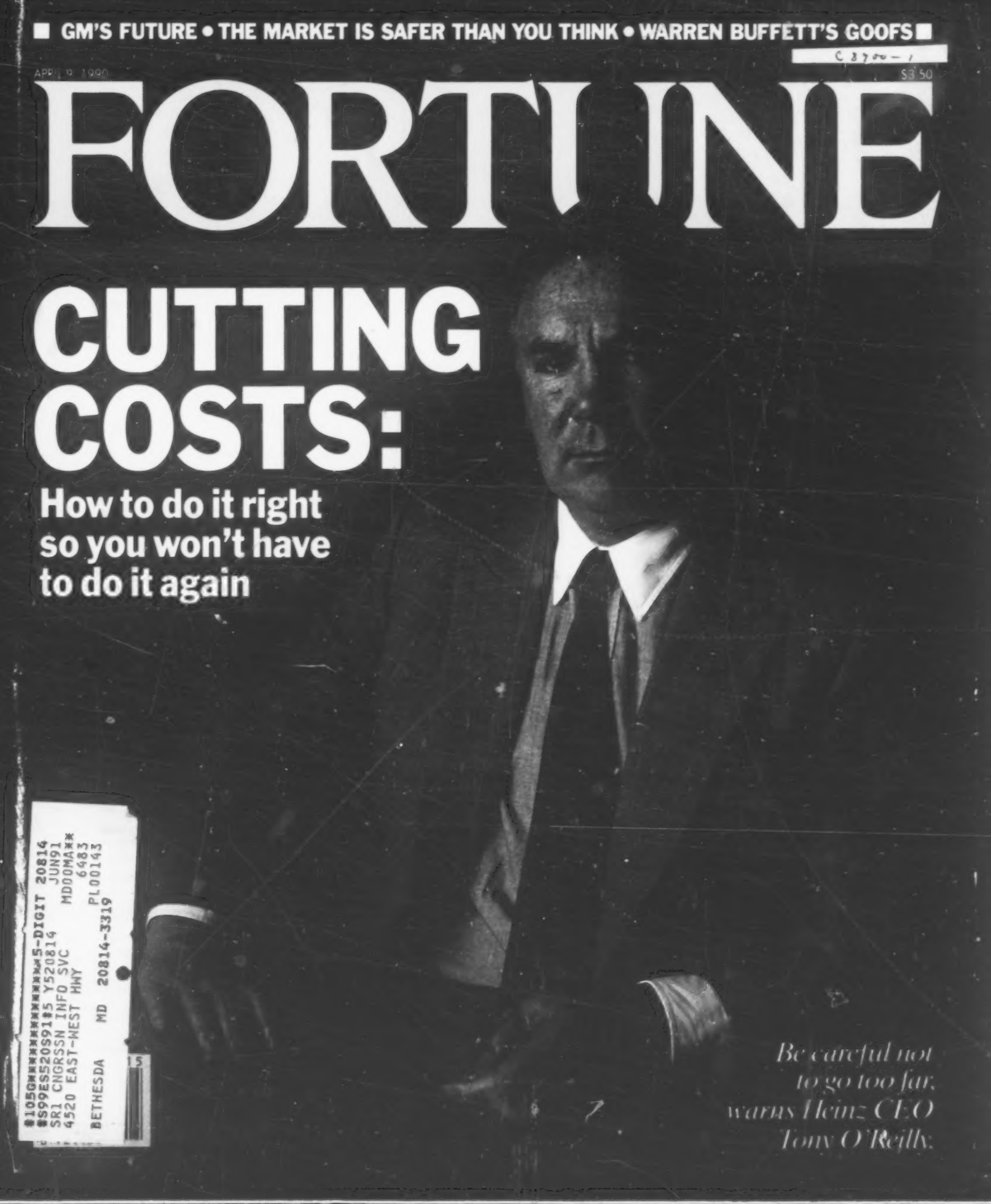
FORTUNE

CUTTING COSTS:

How to do it right so you won't have to do it again



Be careful not to go too far, warns Heinz CEO Tony O'Reilly.

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ABOVE: To improve its Tater Tots, Ore-Ida slowed its high-speed slicing machines, photographed by Glenn Oakley.

COVER: H.J. Heinz CEO Tony O'Reilly, photographed by Michael O'Brien.

"Costs exist for a reason. If you don't take the reasons away, the costs will return."

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So far, downsizing simply hasn't delivered. Companies have gotten leaner, but not fitter. Learning from their mistakes, some managers have taken a new approach to downsizing—cut the workload, not just the work force. This idea even has a name: "right-sizing." *by Ronald Henkoff*

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THE $400 MILLION FRIENDSHIP 85

While amassing his own $3.7 billion fortune in real estate and retailing, Al Taubman has also made a bundle for his chums. *by Alex Taylor III*

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"I haven't seen one guy buy a car because it's got the cleanest tailpipe."

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"Young companies that used to dream of going public are now conniving how they can stay private."

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"We've been developing by borrowing technology from abroad. From now on, we'll do it ourselves."

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"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

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"These guys are trying to keep their stock price up, trying to stay sane, and they don't have time to watch the culture."

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"We have a saying around Bank of America. Kill the messenger only if he's late with the news."

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EDITOR'S DESK

TOP MANAGERS across the U.S. are sharpening their knives, preparing for another round of slashing overhead and slicing jobs. We hope they read our cover story first. As writer Ronald Henkoff makes clear, the most effective cost cutters will go about the task with surgical precision. They will rethink all aspects of their operations, from manufacturing to marketing, and attack the workload instead of the work force. Rather than bring back the brutal downsizing of the 1980s, smart executives will match their companies' strengths to the marketplace in an effort at "right-sizing." Their reward for all this effort: They shouldn't have to do it again soon.

GORDON CHIN

Henkoff: "Managers don't like to admit mistakes."

FORTUNE has been reporting on restructuring—both the corporate and the human side—for at least a decade. The genesis for this story was the simple question: Has cost cutting gone too far? We figured Heinz Chairman Tony O'Reilly was the perfect person to answer it. Five years ago we did a story looking at how he was closing factories, laying off workers, and speeding up production lines. The results—average annual earnings increases of 15%—were laudable.

But when Henkoff caught up with O'Reilly in New York, the Heinz CEO confessed that his earlier strategy had hurt product quality and alienated workers. In Heinz's StarKist tuna canning factories in Puerto Rico and American Samoa, for example, the fish cleaners were so overworked that they were leaving tons of meat on the bone every day. Managers finally slowed down the production lines and added workers. Labor costs went up $5 million annually, but waste was reduced by about $15 million. As Julie Connelly, who edited the story, says, "It's clear that the only thing rampant cost cutting is sure to cut is employee motivation."

Like O'Reilly, many of the managers preaching rightsizing were among the most ardent downsizers a few years back. But getting them to talk was not easy. As Henkoff puts it, "Managers, like most people, don't like to admit mistakes." Still, after seven weeks of working the telephone and climbing onto airplanes, Henkoff turned up enterprises across the U.S. that have found effective new approaches to cost control, from Oryx Energy in Dallas to Eastman Kodak in Rochester, New York.

Henkoff, who concentrates on Midwest companies and business trends from his Chicago base, has been following the restructuring frenzy for several years. Formerly *Newsweek*'s European economics editor, he first reported on the subject in the mid-1980s as such European companies as Philips and Olivetti were paring employee rosters. Since coming to FORTUNE in 1988, Henkoff has continued to watch companies flounder after taking cost-cutting steps that promised more than they delivered. "You can become more efficient at what you're doing," he says. "But that really isn't very helpful if you are doing the wrong thing." His story shows how to do it right.

Marshall Loeb

MANAGING EDITOR

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This Tokyo family has a new status symbol, a Jeep Cherokee.

FOREIGN CAR SALES GO VROOM IN JAPAN

■ Surprise: Japan is the world's fastest-growing major market for imported cars. While Japan's auto exports dropped nearly 4% in each of the past four years, imports grew at an annual rate of 37%. The Japan Auto Importers' Association expects 33% growth this year. By 1995 imports could reach 10% of the country's car market, from 4.5% now.

Behind the surge is a growing Japanese appetite for the status of imported cars plus the buying power of the strong yen. At the same time, the government has eliminated tariffs and harrowing inspection procedures.

West Germans have worked hardest to take advantage of the new market and are the big winners (see chart below). While **Chrysler** CEO Lee Iacocca grumbled that Japanese auto manufacturers wouldn't distribute Chryslers, **BMW** set up its own dealer network. BMW sold 33,076 cars last year, as many per capita as in the U.S. **Volkswagen-Audi**, which has sold its cars through an independent dealer that specializes in imports, will open exclusive VW dealerships this year.

Iacocca still hasn't gotten anywhere with his Chryslers, but within a few weeks **Honda** is expected to announce that it will import his company's Jeeps, which are considered a status buy. At present, Chrysler sells all its products through a tie-up with a Japanese trading company. Honda also imports Hondas from its "transplant" factories in the U.S.

Ford Motor, which owns 25% of **Mazda**, sells cars through Autorama, a cooperative retail venture the two companies control.

General Motors sells its products through an independent dealer that has its own retail systems. (For more on GM, see Autos.) **- Susan Moffat**

JAPAN'S TOP IMPORTED CARS

COMPANY / COUNTRY	REGISTERED IN 1989	% change from 1988
Volkswagen-Audi Group (West Germany)	48,900	24.7
BMW (West Germany)	33,076	23.3
Mercedes-Benz (West Germany)	31,511	30.3
Rover Group (Britain)	10,655	144.6
Citroën-Peugeot (France)	8,494	77.6
General Motors (U.S.)	7,231	49.4
Volvo (Sweden)	7,122	53.7
Ford Motor (U.S.)	5,967	56.7
Honda USA	4,897	-12.9
Fiat Group (Italy)	4,242	5.1
Porsche (West Germany)	4,081	67.2
Jaguar* (Britain)	2,703	63.6
Opel** (West Germany)	2,643	488.6
Saab (Sweden)	2,631	25.1
Chrysler (U.S.)	973	119.6
Kia (South Korea)	973	N.A.

*Acquired by Ford Motor in February 1990. **A subsidiary of GM since 1929.

SOURCE: JAPAN AUTO IMPORTERS' ASSOCIATION

A Maruti in New Delhi for lottery winners only

INDIA'S NEW AUTO: TOO MANY BUYERS

■ When Indian automaker **Maruti Udyog** announced a new model—the Maruti 1000—some 250,000 applications rolled in, ten times what the company will manufacture in 18 months. To handle the demand (and put the brakes on speculators who want to sell the hot car for huge premiums), Maruti Udyog resorted to a lottery. Would-be buyers deposited about $1,500 each, 10% of the car's price, and their names were put into a computer. The drawing, supervised by a supreme court judge, produced the names of the first 25,000 owners. They still face a long wait: Production doesn't begin until October. The losers got their money back.

Maruti Udyog—owned by the Indian government (with 60%) and Japan's **Suzuki Motor** (40%)—made an estimated $30 million in 1989 on sales of $726 million. The lottery produced an $11 million windfall: interest on deposits totaling $369 million. **- Rahul Jacob**

CASTRO'S EXPORTS

■ If you're looking for such classics as a 1959 Cadillac, a 1951 Olds Super 88, or *any* fintail De Soto, Cuba is a good place to go. Barred from buying U.S. cars since the 1962 embargo, owners have preserved the ones they had, many dating to before Fidel Castro's 1959 rise to power. Provided the cars have not been excessively patched with Soviet parts, they are now worth a small fortune in the U.S. A 1959 Cadillac convertible in mint condition sells for $106,000.

Enter the Cuban government, which is desperate for hard currency. It reportedly is selling some of its antique autos to foreign tourists

Hot, a classic Buick in Havana

BY SUSAN E. KUHN

MUNIS, STATE BY STATE: BARGAINS THAT BEAT THE TAX MAN

■ Ah, munificent municipals. For months municipal bonds have been offering sumptuous yields in comparison with their taxable counterparts. Now, with stocks stalled and junk bonds in the dumps, munis may be the best game in town. And you don't even have to look hard for a great deal. The very best bargains are in your own backyard.

Muni appeal is a simple game of numbers. Most experts put a buy order on municipals when their yields equal 80% or more of those for taxable Treasuries. Currently 30-year Treasury bonds are paying 8.6%, while municipal bonds yield 7.3%. The differential: a respectable 85%. That may not sound like a foot-stomping buy, but consider this: To pocket 7.3% from a taxable bond, you'd have to get a pretax yield of 10.1%, assuming a 28% federal tax rate. For those 3.5 million Americans who pay the maximum 33% rate, the required taxable-equivalent yield is 10.9%. Only junk bonds offer such high yields in the taxable kingdom.

Many muni holders achieve even greater returns by buying bonds that are exempt from state and local taxes, as well as from Uncle Sam's take. All states allow residents to hold local muni bonds without paying state taxes on them. While most states exempt only their own issues, Indiana, New Mexico, and Utah extend the break to all munis, no matter where they come from. In Texas and Florida, investors make out nicely despite the fact that neither state taxes income. Both offer higher yields to give their residents an incentive to invest. Most states have at least a few mutual funds dedicated to native bonds. Since state and local taxes can shave 10% or more from your payout, the list is worth checking out.

In states with many funds, it pays to shop around. For example, the average yield of all 46 New York funds tracked by Lipper Analytical Services is 6.7%. But **Rochester Fund Municipals** has an average 12-month yield of 7.4%, while the **Landmark New York Tax-Free Income Fund** has a yield of only 5.8%. In California the range runs wide as well. The **Franklin California Tax-Free Income Fund** yields 7.4%, while some other state funds pay as little as 6%.

The economic risk of holding bonds concentrated in a single state is not as great as may first appear. Heavy issuers—California, New York, Texas—offer a smorgasbord of different bonds. The mix enables mutual fund managers to get broad diversification. Smaller states like Massachusetts offer less diversity, so cautious investors might consider sticking to a fund that specializes in insured munis, which get an automatic triple-A rating. James Kochan, chief fixed-income strategist at Merrill Lynch, thinks the insured bonds are an especially good buy right now.

New York residents may be reluctant to load up on local bonds because the rating agencies are reviewing the state's general-obligation issues for a potential downgrade. The state has plenty of fiscal problems. As credit analyst Maury Cooper at Standard &

BRIAN LEATART

A California resident would need a taxable bond yielding 10.7% to outdo the 6.7% tax-free yield from a state muni bond fund. Bonds issued to finance the Long Beach harbor landfill will help keep California's muni funds well stocked.

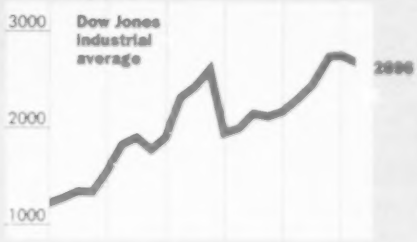
A SAMPLER OF STATE MUNI FUNDS

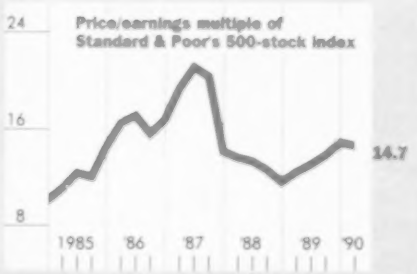
STATE	NUMBER OF FUNDS OFFERED	AVERAGE 12-MONTH YIELD	TAXABLE EQUIVALENT YIELD*	
			Nonresident	State resident
Arizona	5	6.9%	9.6%	10.6%
California	55	6.7%	9.3%	10.7%
Colorado	6	6.9%	9.6%	10.3%
Connecticut	4	6.7%	9.3%	11.6%
Florida	4	7.2%	10.0%	10.0%
Georgia	6	6.5%	9.0%	9.9%
Maryland	7	6.4%	8.9%	9.6%
Massachusetts	18	6.8%	9.4%	11.0%
Michigan	12	6.6%	9.2%	9.8%
Minnesota	17	6.3%	9.2%	10.3%
New Jersey	9	6.3%	9.6%	9.9%
New York	46	6.7%	9.3%	10.4%
North Carolina	4	6.4%	8.9%	9.9%
Ohio	17	6.7%	9.3%	10.3%
Oregon	7	6.2%	8.6%	9.8%
Pennsylvania	13	6.9%	9.6%	9.9%
Texas	4	7.3%	10.1%	10.1%
Virginia	5	6.4%	8.9%	9.7%

*Assumes 28% federal rate and maximum state rate for individuals as of Oct. 1989.

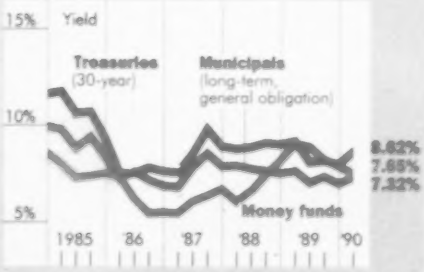
STATE OF THE MARKETS

Stocks

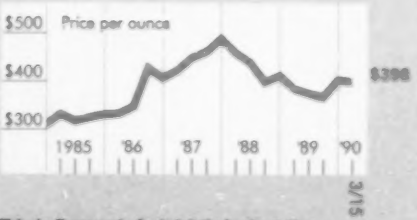




Bonds



Gold



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This is Fortune's fortnightly look at the major markets of the past five years

CHARTS SHOW END-OF-QUARTER FIGURES.

BASED ON EARNINGS FOR THE LATEST FOUR QUARTERS.

SOURCES: STANDARD & POOR'S, BOND BUYER, DONOGHUE'S MONEY FUND REPORT, COMMODITY EXCHANGE

Poor's points out, "New York State cut taxes too far, too fast." But most analysts think investors' fears are overdone. Says John Sebastian, an executive vice president at the Chicago brokerage firm Clayton Brown: "The market has already discounted the possibility of a New York State downgrade, and the idea that New York might default is just absurd."

Ironically, fiscal crisis could well become an investment incentive of sorts, especially for high-income individuals. State legislators are loath to increase taxes, but many are finding they have no choice. Last year, Connecticut, Illinois, and North Dakota raised taxes. In 1990, New York will likely postpone a scheduled cut in its top tax rate, from 7.5% to 7%, and New Jersey's new governor, James Florio, has proposed boosting taxes for the state's wealthiest residents. With more states forecasting revenue shortfalls and more tax hikes likely, more investors will probably seek shelter in municipals.

Mutual funds are not the only route to building a home-state portfolio. Investors can also buy a unit investment trust or purchase bonds individually. The fees and the performance can vary greatly. When you invest in a UIT, you receive a share of the trust, which represents an interest in a defined slate of municipal securities. Trust portfolios, unlike mutual funds, are not actively managed. Investors in a UIT are typically charged an up-front sales commission of 4% to 6%, followed by annual trustee fees, which amount to 0.1%. Mutual funds, on the other hand, usually charge an annual management fee of about 0.5%. Sales charges for mutual funds range from zero to 8.5%.

The canny investor with at least $50,000 can save himself a bundle by buying individual bonds and creating a diversified portfolio free from management expenses of any sort. The best bonds to buy now, say experts, are high-quality (single-A or better) munis maturing in seven to ten years. But be warned: Selling a bond before it matures can incur fees that sharply diminish these savings. Sebastian estimates that transaction expenses related to reselling a $5,000 bond before maturity could run as high as 5% of the face value. If you decide to go it alone, be prepared to love your bonds for a long time.

A LITTLE BUILDER THE BIG BOYS OVERLOOKED

■ It's no secret that engineering and construction stocks are hot. With the nation's infrastructure in disrepair, these companies are promised heady earnings growth in the years ahead. Institutional investors have been plowing their money into such big-name players as Fluor and Foster Wheeler. Since the beginning of 1990, engineering and construction stocks have risen more than 13%, vs. a nearly 17% decline for the S&P 500.

But not all the stocks are breaking new ground. The shares of **Jacobs Engineering Group**, which is based in Pasadena, California, have been left behind. As the price/earnings multiple of competitors ratcheted up, the P/E of Jacobs has remained rather placid at 18 times calendar 1989 earnings.

P/E MULTIPLES OF ENGINEERING/CONSTRUCTION STOCKS

Fluor	29
Stone & Webster	27
Foster Wheeler	25
Morrison Knudsen	19
Jacobs Engineering	18

Reason: With only 5.4 million shares outstanding and only half of those in the float, Jacobs stock has been too illiquid for most institutional investors. But that's changing. With the company's recent move to the Big Board, and a 2-for-1 stock split scheduled for April, trading volume in the stock is expected to improve substantially, and that should draw in big investors.

Although Jacobs's P/E is only slightly below Morrison Knudsen's (see table), it has the potential for far greater profitability. Jacobs concentrates on winning cost-plus contracts, analysts point out, while Morrison Knudsen's work is dominated by riskier government construction contracts—like prisons or Army housing—which must be billed at a fixed price.

Designing and constructing petrochemical and pharmaceutical plants makes up over 40% of Jacobs's $794 million of revenues. Though this part of the business went through a long slump in the mid-

THE NEW DRIVE TO REVIVE GM

Roger Smith's successor will inherit lots of talent and other formidable assets. But the job ahead is to lift profits, win back old customers, and woo young buyers. ■ *by Alex Taylor III*

On sale now: The Chevrolet Caprice Classic has a new flair.

SOMETIME in the next few weeks, the 18 members of General Motors' board of directors will elect a chairman and chief executive to succeed Roger Smith when he retires August 1. The new man will face one of the most formidable challenges in corporate America: revitalizing the core business of the world's largest industrial corporation. GM concedes that its vast North American auto operations have barely broken even for three years, with profits on trucks offset by big losses on cars. The company must be trimmed down to run economically, reorganized to function effectively, and redirected to attract new customers.

After nine years as CEO, Smith, 64, still has a firm grip on the wheel. In recent weeks he has reminded audiences that GM remains the biggest automaker on the globe. He says the company's competitiveness is at an all-time high and predicts that its U.S. market share will reach 37% this year for the first time since 1986.

GM does have remarkable strengths. It sells six brands of cars through five divisions; a sixth division, Saturn, will begin selling GM's new small cars in the fall. Its plants use the most modern machinery of the Big Three, and the company has launched more redesigned models since 1987 than Ford and Chrysler combined. Its technical and research skills and its cadre of experienced executives are unmatched anywhere in the world.

But GM's North American auto operations, which include Canada and Mexico, misfired in the 1980s (see charts). Ford and Chrysler lately have slipped too. At Ford, new CEO Red Poling is struggling to discipline new-model development programs that are behind schedule and over budget. And Chrysler, facing fresh competition for its best-selling minivans and Jeep Cherokees, ultimately may be forced into a merger with a Japanese or European partner. GM, however, is the biggest of the Big Three, and its slide has been deepest and longest.

Robert Stempel, 56: the man who could be CEO

The company sells nearly one-third fewer cars now than it did in 1979—and analysts say that in North America it lost close to $1 billion on them last year alone. GM is Detroit's high-cost producer; model for model, on average, its cars each cost $200 to $300 more to build than Ford's and $750 more than Japanese models made in the U.S., according to Ronald Glantz, a well-regarded auto analyst at Dean Witter in San Francisco.

Nearly all the market share gains made by the Japanese during the last decade have come at GM's expense. *Ward's Automotive Reports*, which publishes the industry's most relied upon statistics, says GM lost 11.6 points—from 46.3 in 1979 to 34.7 at the end of last year—while the Japanese gained 10.4 points. Ford picked up nearly two points, to 22, and Chrysler lost almost three, to 10.3. (By its own reckoning, GM has 35.1% of U.S. car sales. That's because in calculating the total size of the market, it excludes 115,000 Japanese vans and sport utility vehicles that *Ward's* counts as cars.)

GM's new CEO will have to act fast to slow the damage and regain momentum. It is acknowledged within the company that unused factory capacity amounting to one million cars must be written off—and the plants closed—at a one-time cost of more than $1 billion. GM's huge white-collar bureaucracy must be substantially reduced to get costs down and efficiency up. And negotiations will have already begun with the United Auto Workers, whose three-year contract expires September 14.

As usual, the bargaining promises to be difficult. Over the past three years, the UAW says, the average GM hourly employee has received a total of $304 in profit sharing, vs. $7,900 for Ford workers. Among other grievances, the auto workers contend that GM has broken its word by indefinitely laying off workers at three plants without putting the workers into a job bank, where they receive full pay and benefits. GM says the issue is in arbitration.

No one—not even its competitors—can take any pleasure in the plight of General Motors. It is a global institution—a huge employer and buyer from countless suppliers, an enormous force in the world economy and in the many communities in which it operates. What's bad for General Motors is bad for the U.S. If it can return its North American car operations to competitiveness, GM will serve as an inspiration and example to other U.S. companies.

THE QUALITY of GM cars has already gotten dramatically better. That is evident from data compiled by James E. Harbour, a Michigan manufacturing consultant for automakers and suppliers worldwide. In 1980, says Harbour, GM had an average of 740 defects per 100 cars, second worst in the industry after Chrysler with 810 per 100. (Defects are problems that customers notice, such as poorly fitted body panels, squeaks and rattles, and broken parts.) By 1989 the number had fallen to 168 per 100, though GM still lags behind Japanese manufacturers, which have an average of 121 defects per 100 cars, and Ford, which has 149.

Over the next two or three years, GM will also break new ground in styling. On a recent tour of the company's design studio, Chuck Jordan, the Hollywood-handsome vice president of design, whisked the dust covers off nearly a dozen new cars parked in the hallways. Jordan's team has created an imposing new look for the 1992 Cadillac Eldorado and Seville that is as grand and distinctive as any of GM's luxury classics of the 1950s. And it redesigned the slow-selling Chevy Lumina and Pontiac Grand Prix for 1993 and 1993½ with a futuristic cab-forward look that some

Due in 1992: a compact Buick similar to this Bolero show car

PETER UBBARD

PHOTOGRAPH BY WILLIAM COUPON

analysts believe could catapult GM to the leading edge of automotive design.

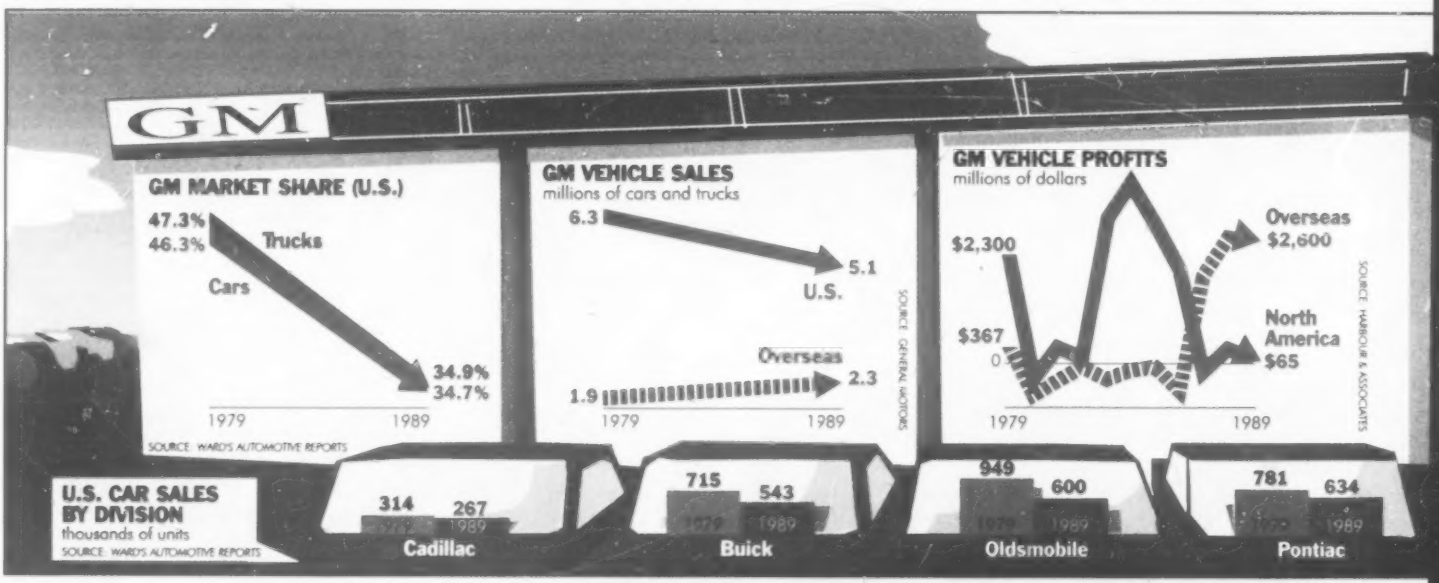
Except for its flagship U.S. car business, GM is thriving. Trucks earned more than $1 billion last year. GMAC, the finance group, contributed another $1.1 billion, and Ross Perot's old Electronic Data Systems kicked in a record $423 million. GM's overseas car operation is healthiest of all; it made $2.6 billion last year, mostly in Europe. Altogether, earnings were $4.2 billion, giving GM its third most profitable year ever.

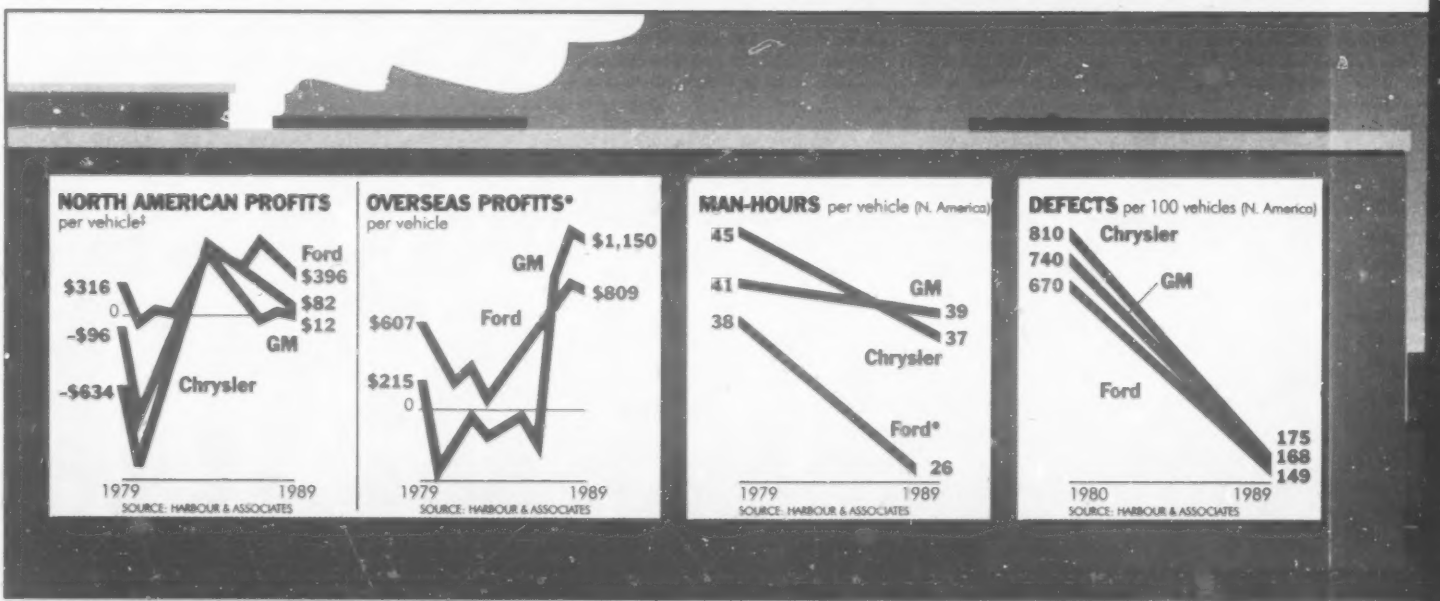
As recently as 1986, GM Europe was a money loser. But after it went through a vigorous cost cutting and developed some snappy new models, the market turned hot and cash started gushing. Unfortunately its success cannot be easily exported. GM Europe sells 60% fewer cars than the North American operation and markets them under just two brands, Opel and Vauxhall. Because it is less vertically integrated, it can buy more parts at competitive prices from outside suppliers. Managers operate with more autonomy than their American peers. And competition isn't as stiff. The Japanese account for only about 11% of European car sales, vs. nearly 26% in the U.S.

Fairly or not, Roger Smith has become a lightning rod for criticism about GM. Smith insists that his changes will ultimately pay off for the company. As he told FORTUNE a year ago, "Please come back in five years and see what I did." But many GM executives want to move faster to shake up the car operations, and they are eagerly awaiting the arrival of the new CEO and his team.

THE WORLD OF GM

In so vast an enterprise, getting all the components moving in the same direction is a major achievement. Since 1979, GM has made big strides overseas. In North America quality is up, but factory gains are scant, and profits and market share are persistent problems.





‡Vehicles in each case include cars and trucks. *Chrysler has no overseas operations. *1988 figure.

There is even some admiration for Ford Motor, where CEO Donald Petersen recently retired early, enabling his successor to forge ahead. Says a consultant who works closely with GM: "I don't know how many GM vice presidents have told me they can't make big changes until Roger leaves."

Some of the company's institutional investors are frustrated. In January, New York State controller Edward Regan, a trustee of pension funds holding over 5.1 million GM shares, wrote to the board of directors noting that GM's stock had markedly underperformed the S&P 500 over the past decade (GM's stock rose 69%, vs. 227% for the S&P 500). Concluded Regan: "We are very desirous of better performance from one of our most major holdings." California controller Gray Davis, a board member of the state employees' pension fund who is also co-chairman of a group of about 60 large pension funds, urges the board to cast widely for Smith's successor. "The company needs new leadership, and it's the outside directors' obligation to mount a worldwide search for it," says Davis. "Tradition is not the answer; it's the problem."

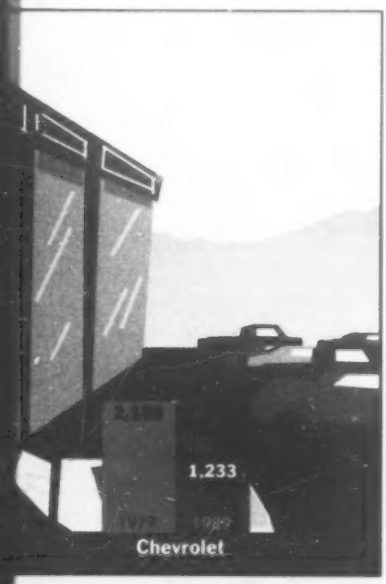
Members of the GM board have pledged not to talk about the CEO selection process, but there are no signs they plan to recruit an outsider. Anne Armstrong, the former ambassador to Britain who is a 13-year GM director and a member of the nominating committee, said in a brief telephone conversation: "We have discussed the possibility of looking at outside candidates. I'm not going to go any further than that."

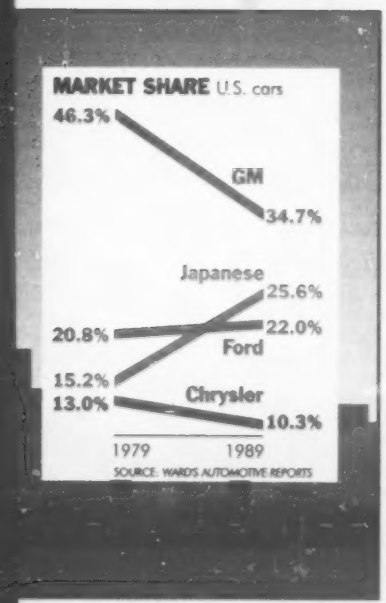
SMITH'S all-but-certain successor appears to be President Robert C. Stempel, 56, who rose through the ranks from transmission design engineer. After 32 years at GM, the indefatigable Stempel knows the car business "from the road to the roof," to use a favorite phrase of his. As the first career engineer to run the company, he would end GM's domination by its financial staff. Under Stempel the company could be expected to concentrate at first more on products than on short-term profits. That would be popular within GM and, surprisingly, on Wall Street, where analysts and large investors view Stempel much the same way they do Petersen—a car enthusiast who rebuilt Ford's product line and guided it to record profits.

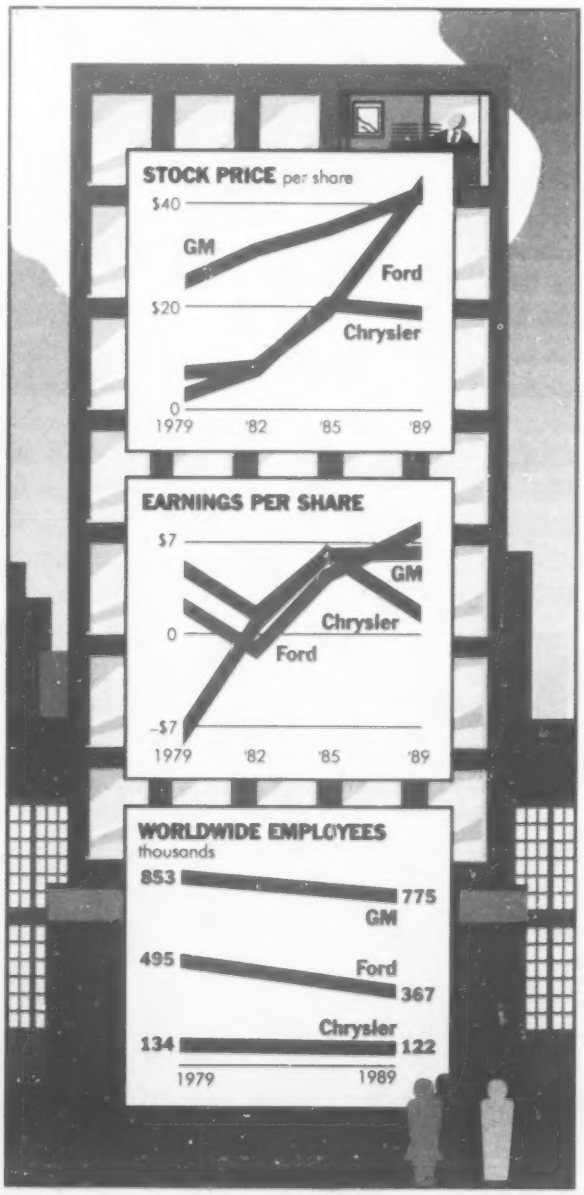
Stempel is a reformer, not a revolutionary. During his 2½ years as president, he has been the ideal second-in-command. In January he flew 1,500 miles from a dealers' convention in Las Vegas to Chicago, where he listened to Smith give a 30-minute speech, then returned to Las Vegas that afternoon. If Stempel has any radical plans for GM, he is keeping them private. Says he: "We made our decision to go with a long-term view, and it's paying off overseas, in trucks, and in our acquisitions. We just have to stay the course in North America."

Like Smith, Stempel is sensitive to criticism and is known to study problems at length before reaching a decision. Also like his boss, he is confident the company is on an upswing. He told FORTUNE that GM will operate at 100% capacity by 1992, vs. 76% in 1989 (Ford ran at 97% capacity last year), regain 40% of U.S. car sales by 1994, and make Saturn profitable by 1995.

The son of a New Jersey banker, Stempel played football at Worcester Polytechnic Institute in Massachusetts and got an MBA at night from Michigan State. At GM he "moved through the chairs" with unusual speed, winning 11 promotions during one 18-year stretch. As head of Opel in Europe in the early 1980s, he began the consolidation of GM's car operations that finally paid off in record profits last year. No buttoned-







REPORTER ASSOCIATES *Jung Ah Pak and Rosalind Klein Berlin*

ILLUSTRATIONS BY JIM MCMANUS

down executive in either style or demeanor, Stempel favors black jodhpur boots and poker chip–size gold cuff links bearing his astrological sign: Cancer.

SEVERAL OTHER GM executives are poised for promotion. Depending on how the new titles are parceled out, their elevation could signal a greater sharing of responsibility among the company's top officers than during Smith's term. One candidate is executive vice president William Hoglund, 55, a lanky, likable Princeton graduate. He helped rejuvenate Pontiac in the early 1980s and then Cadillac in the late 1980s after succeeding Stempel as head of the Buick-Oldsmobile-Cadillac group.

Another man who seems likely to move up is executive vice president John F. "Jack" Smith, 52 (no relation to Roger Smith or to another executive vice president, Alan Smith). The quiet, efficient Smith returned to Detroit last year after a highly successful term running GM Europe, where he launched several popular new models. Smith and Hoglund both started in finance but have won strong credentials as operating executives.

As described by the legendary Alfred P. Sloan, GM's mission is "to cut metal and in so doing add value to it." Historically, economies of scale have paid off big in the auto business, and nobody is bigger than GM, with its 755,000 employees, more than 200 plants and other facilities worldwide, and annual sales of $127 billion. But as more competitors have sprung up and GM's market share has shrunk, its avoirdupois has become a drag instead of a lever.

Satisfied owners who remain loyal for a lifetime generate a revenue stream for 40 years or more.

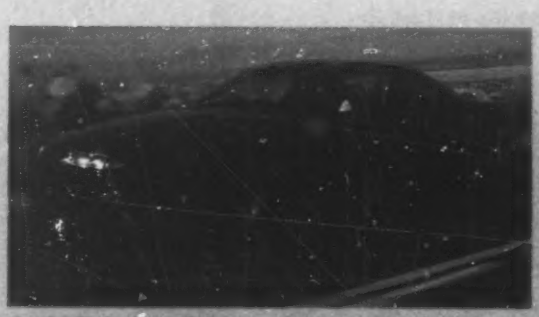
The most telling indication is contained in a profitability analysis of GM's North American car and truck operations given to FORTUNE by a former GM employee. According to him, the analysis was prepared by GM's corporate finance staff. A GM spokesman refused to confirm or deny the document's authenticity.

Analyzing any company's internal financial reports is difficult without knowing the assumptions and accounting principles behind them. GM's methods are more complicated than most because the prices charged by the company's in-house suppliers can inflate the booked costs of the cars. Moreover, budgets can be used for internal strategic or economic purposes that distort the final results. But two knowledgeable security analysts who independently were given copies of the document say it is genuine and presents an accurate picture of GM's U.S. car business. And when asked about some of the forecasts, four high GM executives did not dispute the data.

Dated December 5, 1988, the report projected sales for every car in the GM line for the 1989 model year, which ended September 30. It estimated GM's variable profit, based on direct manufacturing costs, and the company's operating profit—what is left over after capital costs, overhead, merchandising expenses, and sales rebates are deducted. The analysis actually understated GM's losses, because 1989 production ran 10% below projections and cash rebates averaged about $1,000 per car, higher than anticipated. GM says it paid $5 billion in rebates in all

SOME OF GM'S MONEY LOSERS . . .

According to a report two security analysts have seen, the four cars shown on this page were budgeted to lose money in the 1989 model year, while the two cars on the facing page were projected to be big moneymakers. The Grand Prix and the Cutlass Calais suffer from production inefficiencies. The Allanté and Reatta are luxury two-seaters that have not sold as well as GM had hoped. The Brougham and Touring Sedan are profitable because their costs have been amortized and they command a high markup. The pictured cars are 1990 models.



Pontiac Turbo Grand Prix: average sticker price, $25,500

Oldsmobile Cutlass Calais Quad 442: $13,700

Cadillac Allanté: $52,500

Buick Reatta: $26,700

of 1989, up from $4.2 billion in 1988.

Manufacturing and security analysts with whom the document has been discussed say the projections highlight GM's excessive overhead and inefficient plants. The company's biggest losses are coming from its newest cars: the midsize coupes and sedans of the GM-10 line, such as the Buick Regal and Pontiac Grand Prix. They were introduced in the 1988 model year as a belated attempt to compete with the Ford Thunderbird and Taurus. The cars have been a major disappointment, and company officials concede that their four GM-10 plants run at only 60% capacity. GM, for example, budgeted a loss of $1,697 on the Grand Prix. When startup costs for the Chevrolet Lumina were added in, the budgeted operating loss of the GM-10 line came to $2,117 per car in the 1989 model year. According to the document, the company figured to lose $1 billion on the GM-10s. Says a well-informed Detroit automotive consultant, who often develops similar cost analyses on his own: "These numbers are not surprising. They provide a good representation of the financial challenge in front of GM."

Unused plant capacity also made losers of the Buick Riviera, Oldsmobile Toronado, and Cadillac Eldorado. GM spends only $4,000 more building a $29,900 Eldorado than it does a sporty $14,100 Pontiac Firebird. But the trouble-plagued Hamtramck plant where the luxury cars are assembled runs on only one shift because of slow sales. So, according to the analysis, GM estimated it would lose $1,250 on each in the 1989 model year. Two low-volume, expensive two-seaters designed as "image cars" were particularly costly. Budgeted operating losses on the $52,500 Cadillac Allanté approached $8,000 per car. And GM figured to lose about $17,000 on every $26,700 Buick Reatta.

Says Stempel: "I do not plan to get rid of any divisions, and, no, we do not plan to merge any of them."

GM continues to make strong profits on light trucks and several older lines of more traditional big cars: the Oldsmobile 98, including the Touring Sedan, and similar Buicks and Cadillacs. They were budgeted to produce average operating profits of $3,685 each in model year 1989. The plants where they are built operate closer to capacity, and the tooling, which is amortized over four years, is paid for. The same is true for the gargantuan $29,300 Cadillac Brougham, built with vintage body-and-frame construction. The document said it would generate a $5,257 operating profit per car.

Heavy rebates made profits scarce for both American *and* Japanese automakers in 1989, and that trend has carried over into 1990. The car companies have had a particularly tough time earning money on small cars because of intense price competition. Ford concedes that its subcompacts, such as the new Escort, lose money and that its compact Tempo and Topaz are only marginally profitable. GM has never acknowledged losing money on any model. But the internal document shows that it budgeted losses on all three of its small-car lines in model year 1989. The biggest losses—$522 per car—came on a line of older cars that includes such models as the Pontiac Grand Am and Buick Skylark.

Even with its hefty margins on trucks, GM's profitability is declining more than its competitors' because it is losing so much on cars. A study by Harbour & Associates, James Harbour's consulting firm, shows that Ford's earnings on cars and trucks peaked at $706 a vehicle in 1987 before falling to $396 last year. GM's profitability per vehicle in North America reached a high of $588 in 1984 and has been headed downhill since, reaching $12 last year. Overseas the direction has been exactly the reverse: GM made $215 per vehicle in 1979—and $1,150 in 1989.

At home GM's sinking car sales are eroding its base of loyal customers, with potentially costly long-term consequences. Satisfied owners are the best source of future sales and those who remain loyal for a lifetime generate a revenue stream for 40 years or more. Says Stempel: "A guy who has bought anywhere from 15 to 25 vehicles over his lifetime is a great contributor to our bottom line. We lost some in the 1980s."

Ordinarily GM could expect to replenish its owner base with aging baby-boomers. But according to a 1989 survey of 35,000 car owners across the U.S. by J.D. Power & Associates, the highly regarded California research firm, customers under 45 prefer Japanese cars almost 2 to 1 over GM cars. Ford fares somewhat better, Chrysler a little worse. Says Christopher Cedergren, senior analyst at J.D. Power: "The baby-boom and baby-bust generations buy 55% of all new cars, and they rarely shop GM products." GM recently completed a confidential study called Adopt/Retain to determine whether the baby-boomers are likely to retain a preference for Japanese cars for years to come or whether, as they age, they will adopt their parents' habit of buying GM cars. Among the findings: Older buyers do like the company's big, roomy cars.

FOR NOW, market analysts expect GM's sales to keep sliding. DRI/McGraw Hill sees the company's share sinking to a low of 31.5% in 1993—despite the addition of 240,000 Saturn sales—and then recovering somewhat to 32.1% in 1994 as new designs catch on. Analysts at J.D. Power posit two scenarios. In the most optimistic, Ford goes into reverse, the Japanese stall, and GM accelerates to 40% of the market. Stempel says that's his goal, and a couple of hot

. . . AND MONEYMAKERS

Cadillac Brougham: $29,300

Oldsmobile Touring Sedan: $26,200

models could put the company close.

But instead of pushing all out for a blockbuster, GM has temporarily stopped work on some new models to save money in the first half of 1990. Power's Cedergren thinks GM's goal is "far-fetched." A more likely outcome, he says, is that the Japanese keep growing, Ford holds on to its 22% share, and GM dips to 29% by 1995. In this scenario, after projecting sales for every model in GM's lineup, Power determined that Oldsmobile and Buick combined could be selling only 770,000 cars in 1995, down from more than 1.1 million last year. That would make it tough to support the current network of 6,000 Oldsmobile and Buick dealerships, though Stempel insists, "I do not plan to get rid of any divisions, and, no, we do not plan to merge any of them."

During the 1980s GM spent $77 billion on modernized plants, automated equipment, and new models. Yet a 1990 report by Harbour & Associates says GM reaped only minor improvements in productivity. The report was compiled after a year-long analysis of publicly available data from the Big Three and their foreign competitors; it was published as a sequel to a similar report by the firm in 1979. Since Jim Harbour did not have access to internal company reports, he could not account for such factors as overtime or absenteeism. While he cautions that his statistics are approximations, nobody, including GM, has disputed his overall analysis.

Harbour says GM's car and truck assembly efficiency improved only 5% during the 1980s, vs. 31% at Ford. In 1989 it took 39 hours to build a vehicle at GM's plants, vs. 37 hours at Chrysler's and 26 at Ford's. Productivity at the recently modernized factory in Doraville, Georgia, that assembles the midsize Oldsmobile Cutlass Supreme has fallen 6% since 1979, according to Harbour, partly because the plant is running well below capacity. Doraville requires twice as many workers per car as Ford's comparable midsize-car plants.

GM invested several billion dollars during the 1980s on high-tech press lines that stamp out sheet metal body parts. Yet Harbour says GM's stamping productivity improved only 14%, while Ford, which spent a fraction as much, got a 45% boost. He says GM designers were unable to create new car models that capitalized on the presses' capabilities. GM responds that productivity at Ford plants appears higher because employees work more overtime.

Since 1984, GM has committed more than $2 billion to train and educate its employees. Even so, it admits that it underestimated the skills needed to use the sophisticated new equipment. The inefficiencies that followed, combined with falling sales, hurt GM's productivity and its cost structure. Concludes Harbour: "If GM were as efficient as Ford, it would require 60,000 fewer workers [GM had 419,000 employees in the U.S. in 1988], and it would gain $3.3 billion in annual pretax profit."

THE MOST TROUBLESOME element in GM's overhead remains its army of 100,000 white-collar workers in North America. "GMers look at the way they do business as a sacred cow and don't realize that they aren't functioning internally," says an outside management consultant who does work there. "More time is spent on meetings than anyplace I've ever seen, but less is accomplished."

GM has cut 40,000 people in four years from its white-collar work force. Yet, says David Cole, director of the Office for the Study of Automotive Transportation at the University of Michigan, "GM still has overhead coming out its ears." Stempel acknowledges that more cuts are necessary but says they won't be drastic. Eugene Jennings, a professor emeritus at Michigan

THIS MAN KNOWS WHAT A CHEVY IS

GM President Robert Stempel can parse a suspension with as much zest as he can a ten-day sales report. He spoke with Alex Taylor III about GM's future.

On thinning management:

We need to delayer the organization and restructure to eliminate redundancies. In our plants we've had seven layers from the plant floor to the manager, and in some plants we are now down to four. We're looking at our staff operations to see if they are duplicating our operating activities. Blending them will take out some people. In the case of our engine plants, we're looking at bringing the engineering staff functions in with the operating guys. If it is better in the personnel area to have a central personnel function serving five or six plants as opposed to each one having its own, then we will probably centralize that.

On cutting manufacturing costs:

After we converted to front-wheel drive in our small-car lines, lo and behold, we wound up with 14 or 15 different kinds of drive shafts, a half-dozen rear suspensions, and so on. Now it's time to say, "Okay, guys, among that array of components, which ones are best for what we're trying to do?" Drive shafts on one particular car line will come down from over a dozen to two. That's where the economies of scale start to go up.

On Saturn:

Saturn is intended to be a profitable small car built in North America. We've said that for years. We're on track to do it. We are committed to building small cars for profit in this country. If you can't, it's only a matter of time before you can't do it for midsize cars, you can't do it for full-size cars.

On federal emission requirements:

We told the Bush Administration that its standards were probably uncalled for, but we'd try our best to meet them. Well, Congress got hold of them, and they became the opening bid in the poker game. The fact is, no one in the world knows where the technology lies. We're going to have to invent it, and that's going to be very costly because we're not going to take performance or fuel economy away from the customers. I haven't seen one guy buy a car because it's got the cleanest tailpipe.

On selling American cars:

I think every domestic maker has seen a generation of people who don't even know what a Chevrolet, Ford, or Plymouth is, but know very well what a Honda, Toyota, or Nissan is. These people are the ones to whom we simply have to say, "Hey, we've got some good cars of interest to you too." But we've got to build a car that's equal to or better than [Japan's] in features, shape, size, and appearance.

Lanky, likable William Hoglund, 55, may be promoted soon.

State's business school and a longtime student of GM, makes a downright draconian recommendation: 40,000 to 50,000 white-collar workers ought to be let go immediately, he says, and the organization compressed to remove excess layers of management and redundant functions. Marketing and engineering, for example, are staffed at the corporate, group, and division levels.

More and more it is apparent that GM's 1984 reorganization injected Novocain into the system instead of adrenaline. By creating two new car groups to take over the functions of planning, engineering, and manufacturing, GM, in the words of a management consultant who works at the company, "introduced a whole new layer of bureaucracy and further diffused responsibility. People make group decisions: If something fails, everyone takes the blame."

The reorganization is likely to be GM's most ambitious attempt to grasp its historic Golden Fleece: leveraging its enormous scale. By centralizing engineering and manufacturing in two car groups, it believed that it could eliminate some unique models and build a few basic designs that each division could tailor for its own customers.

BUT GM was already huge. Before the reorganization, Chevrolet, Pontiac, and Oldsmobile each sold more cars than Chrysler. The reorganization not only made it less nimble but also went against the trend toward smaller-volume, custom-tailored models. Says a high-ranking executive at a Big Three competitor: "We were all brought up to believe in economies of scale, but the days of pumping out 300,000 versions of a single car are gone."

GM's product development system still fails to allow the separate car divisions to sufficiently differentiate themselves. All models are styled by GM's central design staff, a fiefdom of its own that reports up through two layers to the chairman of the board without going through any car executive. Division heads must negotiate with the design staff on styling for the cars they sell. "Not all of them are all that clear on what they want," says design boss Chuck Jordan.

Building cars by committee produces cars only a committee can love. Since the reorganization, GM has not had a single smash hit like the Ford Taurus or Honda Accord. *Consumer Reports* recently rated Chevrolet's newest car, the Lumina, beneath Ford's five-year-old Taurus in design and performance. And the American Automobile Association's automotive engineers were quoted in an AAA newsletter saying the Lumina "easily improves on the nine-year-old Celebrity but still lacks features on competing cars. Lumina, although new, still feels old." That is not a surprise since, according to Jordan, the Lumina was originally designed as a 1982 model. It was delayed, incredibly, for seven years because of development problems and disarray from the reorganization.

The new system presses tightest on GM's three divisions in the middle of the market that already had the greatest tendency to overlap: Buick, Olds, and Pontiac. Some 80% of their cars vary only slightly in price and engineering. The styling and image, though different, is not sufficiently distinctive to keep sales from falling. Buick's dropped 7% in 1989, Pontiac's 12%, and Oldsmobile has gone from selling 1.1 million cars in 1984 to just 600,000 in 1989.

Ask an Olds executive what makes his cars different from Buicks or Pontiacs, and he will hand you a laminated three-by-five card with the "Oldsmobile mission statement" on it. To jump-start sales, GM gave Olds a minivan and a four-wheel-drive sport utility vehicle to sell, but even those were originally designed for other divisions. Some Olds dealers are so angry about their declining fortunes that they stormed out of a meeting with general manager Michael Losh at Las Vegas in February after he refused to authorize factory rebates to dealers for the new Olds minivan.

While GM executives continue to praise the reorganization in public, bits and pieces keep coming undone. When Cadillac's unique identity started to blur under the pressure of corporate homogenization, the company agreed to give its most prestigious—and profitable—division its own engineering team. Cadillac embarked on an expedited project to make its cars longer and heavier, and *Ward's* says it was the only GM division that did not lose sales last year.

So may John Smith, 52, who led GM Europe to record profits.

Analyst Maryann Keller, a managing director of Furman Selz Mager Dietz & Birney and GM's most authoritative and vocal critic, has long argued that GM can return to glory only if it gives the same kind of autonomy to its other car divisions as it did to Cadillac. No fan of Keller's, Stempel refuses to consider the idea. Says he: "One reorganization is enough for anyone's lifetime." His strategy is to continue to differentiate models through design and extra features—which the customer can see—while cutting costs under the sheet metal by using more common parts.

Seventy years ago GM went through a similar crisis. When Alfred Sloan was confronted with seven overlapping brands in the 1920s, he jettisoned three money losers—the now forgotten Oakland, Scripps-Booth, and Sheridan lines—and imposed strict price segmentation on the rest. The strategy worked for half a century.

Sloan, of course, never had to cope with the Japanese, and Ford was still in the hands of its eccentric founder. But he set a good example. GM urgently needs to slim down, focus its resources, and sharpen its aim. While it lumbered through the 1980s preoccupied with its own concerns, the world changed. Soon, with new leadership, GM will have a chance to change with it. F

INVESTOR'S SNAPSHOT

GENERAL MOTORS

SALES (latest four quarters)	**$126.9 BILLION**
CHANGE FROM YEAR EARLIER	UP 2.7%
NET PROFIT	**$4.2 BILLION**
CHANGE	DOWN 13%
RETURN ON COMMON STOCKHOLDERS' EQUITY	**12.1%**
FIVE-YEAR AVERAGE	11.9%
STOCK PRICE RANGE (last 12 months)	**$39.125-$50.50***
RECENT SHARE PRICE	**$46.25**
PRICE/EARNINGS MULTIPLE	**7**
TOTAL RETURN TO INVESTORS (12 months to 3/9)	**16%*†**

*Adjusted for 2-for-1 stock split paid out 3/31/89.
†Does not include Class E and Class H stock.

THE COMING WORLD LABOR SHORTAGE

A baby bust will soon shake industrialized economies everywhere. To cope, they must start encouraging immigration and discouraging early retirement. ■ *by Louis S. Richman*

AGE HEALTHFULLY, retire earlier, and bank on ever richer government benefits. For nearly 50 years, political leaders in North America, Japan, and Europe have promised their citizens varying versions of that bright future. But as the next millennium approaches, it's looking less and less likely that those promises will be kept. The problem: too few workers and too many retirees.

During the building of their postwar welfare systems in the 1950s and 1960s, countries everywhere could count on rising numbers of young workers to enter the labor force and carry the cost of state-sponsored pension and health insurance programs. But beginning in the late 1960s, America's baby boom, and the corresponding boomlet in Western Europe, turned rapidly into baby busts. Since the early 1970s, birthrates in almost every industrialized nation have dropped below the 2.1 offspring that women of childbearing age must produce, on average, for a country to replace its population.

As a result, a demographic San Andreas fault now runs beneath the economies of the West. Will it cause an earthquake? Yes, most likely a big one. Says R. Scott Fosler, vice president of the Committee for Economic Development, a business-backed public policy research group: "Population pressures are as strong as they are inevitable. And the population pressures we face today are without precedent in human history."

The first gentle tremors have already begun. Barring an immediate and sustained upswing in birthrates—a most unlikely prospect—they will strike with gathering force after the turn of the century. Among the consequences:

■ **Companies will grow increasingly desperate for young workers.** Recently, Japan's Ministry of Labor surveyed 268 companies and found that they were already unable to recruit even a quarter of the new workers they would like. Over the coming decade, the

REPORTER ASSOCIATE *Constance A. Gustke*

These retirees are dancing at a "strawberry festival" in Florida. By the early 21st century, the U.S. will be straining to carry far too many old folks . . .

number of new job seekers under age 25 will decrease 3.6% a year in West Germany and about 2% in Britain, France, and Japan. The result: Work forces in Europe and Japan will actually contract. In the U.S., the native-born labor force will still grow, but at the slowest rate since the 1930s—less than 1% a year.

. . . with too few of these—high school kids in Oakland, California.

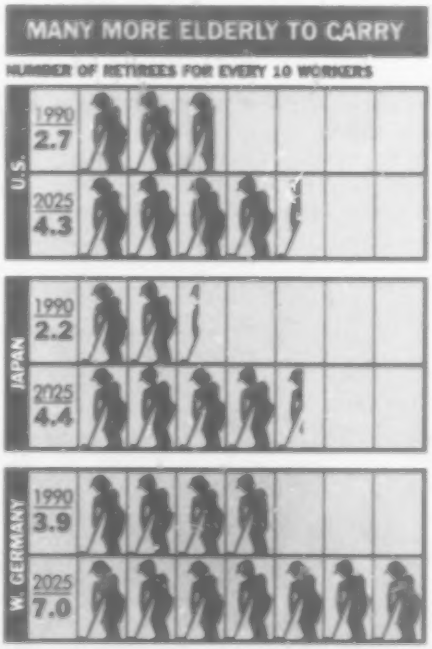
■ Societies everywhere will get a lot grayer. By 2030, people over 65 could account for 22% of the populations of the seven biggest Western economies, up from just 12.5% in 1980. And aided by advances in medical technology, the ranks of the older old—those living beyond 75—are rising even more swiftly. They now constitute the fastest-growing population segment in almost every major industrialized country. Unless the trend toward earlier retirement is reversed, many folks will spend more years as retirees than as workers.

■ The cost of supporting the old will grow nearly unbearable. By 2025 what economists call the dependency ratio—the proportion of pensioners 60 or older to all workers—will have roughly doubled in Japan, the U.S., and West Germany (see chart). If the present benefit systems are kept in place, U.S. programs for the elderly could consume 50% of the federal budget by then. In Italy government spending on pensions is projected to rise fivefold over the same period, even after adjusting for inflation. If the system isn't to collapse, payroll taxes will have to keep pace. (Italy, you will recall, is the birthplace of Signore Ponzi, whose get-rich scheme also required a constantly expanding inflow of newcomers to let older investors cash out.)

■ Immigrants will bang on the doors of the developed world as never before. The baby bust hasn't hit the Third World yet. Over the next 20 years the working-age population in developing countries will rise by roughly 700 million—just about equal to the *total* current population of North America, Japan, and Western Europe. Unskilled workers in the rich nations can expect that growth to exert powerful downward pressure on their wages. Says John Sewell, president of the Overseas Development Council, a Washington, D.C., think tank: "The work-hungry multitudes of the Third World will either descend on the developed economies in a flood of migration, compete with increasing success for the low-skilled and semiskilled jobs that will migrate to them, or most likely, do both."

None of these are issues that parliamentary democracies find easy to tackle. Says Paul Johnson, an economic historian at the London School of Economics: "Because population trends never affect politicians before the next election, they reinforce governments' tendencies toward long-term irresponsibility."

Nevertheless, their common demographic problem will eventually force the U.S., Japan, and Western Europe to focus on three options. They should find ways to expand their domestic work forces and encourage more immigration. They should boost productivity so that their economies can better carry the burden of more elderly dependents. And they should rethink public pension and health care policies. Herewith an account of the particular challenges each society will face in the years ahead—and how each will probably respond.



Divide the nonworking elderly over age 60 by the total work force and you get what economists call a dependency ratio. Another name for it: trouble.

JAPAN

Nowhere will the shocks hit harder or earlier. Japan's elderly population is growing at nearly twice the West German rate and six times that of the U.S. By century's end, what had been the world's youngest industrial society 20 years earlier will have become the world's oldest. A recent report by the Japan Federation of Employers calls this "the most difficult problem facing Japanese companies."

One likely casualty: those companies' longstanding reliance on rigid promotion and pay systems based on seniority. To attract the young, Japanese business may be forced to shrink the wide gap that now exists between the salaries of recruits and older workers and to promote newcomers faster. Another casualty will be Japan's vaunted savings rate. One reason the Japanese are such savers is that no other developed economy expects its old folks to finance so much of their retirement. Employer-paid pensions are skimpy—usually a lump-sum payment equal to just over three years' salary. Government benefits are relatively meager too. But as more workers retire and begin drawing on the money they have set aside, many forecasters predict that Japan's savings rate could fall 50% by the early 21st century.

Compared with their American and European peers, a far higher proportion of Japan's elderly stay in the work force. Over a third of all men and 16% of all women over age 65 are employed, mostly in low-skilled, part-time jobs. But they could be put to more productive use elsewhere. Currently more than 75% of them toil in agriculture or in Japan's notoriously inefficient retail distribution system—two sectors that U.S. trade negotiators have flagged as unfairly impenetrable to outsiders.

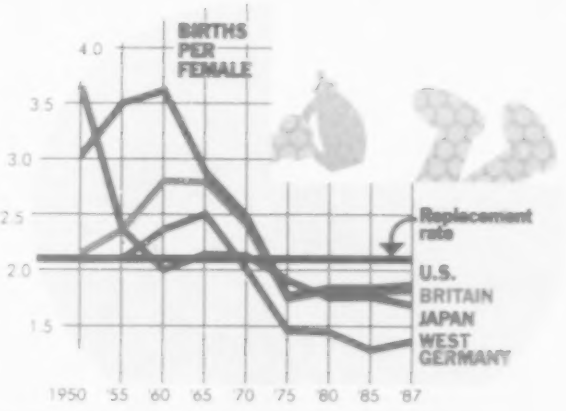
Japanese women are a relatively untapped labor source. But the burden of caring for dependent parents has recently begun to force growing numbers of the

women who do work to quit or take leaves. More than two-thirds of Japan's senior citizens live with their children, vs. a tiny fraction of America's elderly. To make it easier for women to balance jobs with family responsibilities, the government has launched a crash program to build 9,000 new day care centers for the old by the year 2000.

Xenophobia will probably continue to close off this island nation's most promising source of new labor—immigration. Even the employers' association opposes letting in more foreign workers. Of the 80,000 legal migrants to Japan in 1988, 88% were entertainers and sports figures. And the government recently stiffened laws that fine employers who hire illegal immigrants. Some 14,000 illegals were caught, about half of whom were low-skilled construction and factory workers. Most of the remainder were Filipino and Korean domestics, bar hostesses, and prostitutes.

To break their labor bottleneck, Japanese companies are opting instead for heroic increases in capital spending (see The World). By installing advanced automobile manufacturing technology, for example, Toyota hopes to boost car output by at least 30% without adding the 3,000 new workers such an expansion would otherwise require. Though Toyota's new cars are meant to satisfy rising domestic demand, some foreigners worry that Japan Inc.'s collective investment in efficient, expensive robots could aggravate international trade frictions. If growth at home falters, those additions to output could turn into unwelcome new exports.

Still, such tensions should be partially offset by Japan's continued willingness to export jobs as well. The Ministry of International Trade and Industry (MITI) estimates that Japanese direct foreign investment will average 14% annually through the 1990s, with much of that money going to build factories in the developing economies of Southeast Asia. MITI projects that by 2000, employers will have shifted some 800,000 jobs offshore.



HOW THE BABY BOOM WENT BUST

According to demographers, societies shrink when women of childbearing age fail to produce, on average, at least 2.1 offspring.

EUROPE

Because their unemployment rate—nearly 9% by the latest count—remains high compared with those of Japan and the U.S., the Common Market countries are well-cushioned against any immediate labor pinch. But a pinch is coming all the same. In West Germany, the most extreme case, birthrates now average just 1.3 *kinder* for every childbearing woman—a trend that, if continued, would guarantee that country's extinction in the not-so-distant future. Nor is the opening of the border with Eastern Europe the demographic godsend it might seem. Birthrates there, though slightly higher than in the West, are also below replacement levels.

Wrongheaded retirement policies are compounding Europe's long-term labor troubles. Since 1970 work force participation rates among those ages 55 to 64 have fallen more than 20 percentage points on average. Today nearly half of all European men and some two-thirds of all women in this age group are retired. And, unlike Japan and the U.S., which restructured their social security systems in the 1980s to build up trust funds for the eventual retirement of today's workers—even if only with government IOUs—European public pension systems operate hand to mouth. Reserves of the West German pension fund are just two months deep.

The march toward a single European market after 1992 is giving the Old World's economies some much needed flexibility. Manufacturers from the high-wage countries in the north, for example, have been scrambling to open plants in low-wage Spain, where unemployment nonetheless hangs at 16%. But there are limits to what Project 1992 can accomplish. In Europe, as in the rest of the industrialized world, most of the new job growth will be in services. Says Paul Johnson: "Even if all its political frontiers disappear, Europe's language frontiers will remain an obstacle to the export of service jobs."

Eventually European governments will have to dismantle schemes that now encourage their fiftysomething set to chill out prematurely on the Costa del Sol. Put in place in the mid-1970s and early 1980s, when unemployment took off, these plans typically offer workers generous disability and long-term unemployment compensation to tide them over until they reach pensionable age. Almost half of West Germans eligible to claim a state pension at age 60, for example, enter retirement after having first participated in a disability program.

Winfried Schmähl, who advises the West German government on pension policy, estimates that if the average retirement age of German workers, currently just under age 60, remains unchanged, payroll taxes will rise from 18.5% of paychecks to over 41% by 2030. Keeping older workers on the job just one year longer, he figures, could re-

North African laborers are picking up a growing share of the harvest on Italian farms.

DENIS REGNIER—CONTRASTO

duce that impending payroll tax bite to around 38%.

Right now, no European politicians are advocating taking anything away from their elderly. But for most, the obvious alternative—absorbing more labor from people-rich places like their former African and Asian colonies or countries such as Turkey—is even less palatable. Drawn by the brighter employment prospects that the single market holds, such workers, who last arrived in great numbers in the early 1970s, are starting to wash up on Europe's shores again. So far the European Community countries have responded by tightening immigration laws, with a few halfhearted exceptions like the amnesty that the Italian government is currently offering illegal immigrants.

But Norbert Walter, chief economist with Deutsche Bank, thinks that predictable reaction is shortsighted. A more liberal policy, he argues, would help both Europe and its neighbors. Says he: "Our economies have never faced such a massive change in age structure at a time of such rapid technological change and increasing global competition." One sensible step he advocates is to set aside places in European universities for more Third World students, as the native-born's number declines.

Immigrants wait for good news in a Tokyo visa line. Only a few will get to stay.

Lavish retirement centers cater to Japan's record-breaking numbers of elderly.

UNITED STATES

No country is better positioned to cope with demography's future shocks than the U.S. During the 1990s America's working-age population will be the largest and most productive in its history. Some 78 million baby-boomers who depressed productivity as neophytes in the 1970s and 1980s will be reaching their mid-30s and 40s as seasoned, mature employees. Meanwhile, the proportion of new retirees to workers will decline for a while.

The danger is that the U.S. will be lulled into an unwarranted sense of complacency. By 2000, when the oldest of the boomers will be 55 and thinking about early retirement, the Medicare trust fund could already be exhausted. A study for the Ways and Means Committee in Congress estimates that if Medicare outlays grow by just 1% a year beyond current baseline estimates, annual deficits in the elderly health care system will top $180 billion by the late 1990s.

As the boomers start retiring in droves after 2010, federal spending on the elderly—29% of the budget today—will soar. How high? That's anybody's guess. Just don't count on the Social Security Administration to guess right. For example, the SSA expects U.S. birthrates to rise from the current 1.8 children per fertile woman to near replacement level by 2000 and remain there. But with nearly 70% of all women of childbearing age in the work force, contraception all but universal, divorce rampant, and one pregnancy in four ending in abortion, that assumption looks like fantasy. Should birthrates drop, instead, to the 1.6 rate assumed in the SSA's more pessimistic scenario, spending to support retired baby-boomers will exceed the fund's projected income by 35%.

The work force shouldering that awesome burden will be more diverse than any in America's postwar history. Netting out arrivals and departures, over 80% of the additions to the work force in the 1990s will be blacks, Hispanics, recent immigrants, and women—increasingly, single mothers supporting dependent children.

Moreover, a terrifying gap looms between the skills that employers need and the training that this new work force will have received. The Bureau of Labor Statistics estimates that jobs requiring a college degree will rise from 22% of the total to 30% by the end of the century. But college enrollment among black youth declined 7% in the past decade. Among Hispanics, the fastest-growing group of new labor force entrants, the high school dropout rate is 40%, triple the national average. Says Frank Doyle, senior vice president of corporate relations at General Electric: "The demographic shortfall is being compounded by a severe educational deficit."

That deficit will only worsen if America's family structure continues to weaken. Nearly a quarter of the 3.8 million births recorded in 1987 were to unmarried women—a 40% increase since 1980. Some 62% of all black infants were born out of wedlock, one-third to teenage mothers. Today, 60% of black children and 20% of white children live with a single parent, and poverty in these households is widespread. The Committee for Economic Development calculates that if these trends continue, by the year 2000 the U.S. could have as many as 20 million young working-age adults with poor prospects of holding *any* job.

Obviously the nation cannot afford to squander so much potential talent. But what

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is to be done? Says GE's Doyle: "For U.S. corporations, tomorrow's competitive battles will be won or lost on the strength of their ability to build and retain a skilled work force." The weapons for waging that battle begin with effective preschool programs like Head Start and extend to expanded, career-long, on-the-job training by employers.

The U.S. should also rethink its immigration policies. No society in history has proved more able to absorb large numbers of immigrants successfully. Over the past decade, America opened its doors to nearly 600,000 new migrants a year—the greatest

"The form and fit of American life is still geared to a steady supply of large numbers of young people, who just aren't going to be there in the future."

number since the early 20th century. But the country needs more—as many as a million a year—to compensate for its low birthrate.

Would more immigrants hurt workers born in the U.S.A.? Almost certainly not. In a newly published book, *The Economic Consequences of Immigration*, Julian Simon, a professor of business administration at the University of Maryland, concludes, after an exhaustive study, that immigrants contribute far more in taxes paid—including Social Security taxes—than they consume in welfare benefits. He also demolishes the myth that immigrants take jobs away from the native-born. "There are lots of painful antidotes to America's demographic pressures," Simon says, "but allowing in more immigrants is the only painless one."

In addition, the U.S. should follow the lead that Canada and Australia have taken and admit more immigrants on the basis of their education and skills. Right now such decisions depend almost exclusively upon whether an applicant has relatives who have already been accepted into the U.S.

America's other huge source of potential new labor is the elderly themselves. According to the National Center for Health Statistics, nearly two-thirds of the U.S. populace ages 65 to 74 are hale and

hearty. But those willing to keep working confront serious disincentives. For starters, once retirees under 70 reach an earnings ceiling of $9,360, the Social Security benefits that they receive fall by $1 for every $3 they earn. Add on state, local, and Social Security taxes, and would-be older workers can pay a marginal tax rate of more than 80%.

Small changes could make a big difference. When Congress reformed the Social Security system in 1983, for example, it agreed to raise the age at which retirees receive full benefits from 65 to 67 over a 24-year period, starting in 2003. But it kept the age of eligibility for collecting at least partial benefits at 62. Princeton University economist Alan Krueger estimates that if this early retirement option were lifted to age 65, workers in the 62-to-64-year-old group might produce as much as $25 billion in new tax revenues.

For generations that have come to view early retirement as their inalienable right, the suggestion that they should stay at work longer is the moral equivalent of castor oil. But combining such changes with steps to permit more flexible employment options *during* one's working life could make them easier to swallow.

JUST IMAGINE that employers make more room for experienced retirees to take part-time jobs. What would happen? Younger workers might be freed up to return to school for further training, single mothers to spend more hours with their dependent children, and the increasing number of Americans who must devote time to the care of aging parents given a much needed break. Such a radical shift makes social as well as economic sense. Says Ken Dychtwald, author of a recent book entitled *Age Wave* and chairman of a consulting firm bearing the same name: "The form and fit of American life is still geared to a steady supply of large numbers of young people, who just aren't going to be there in the future. As our country ages, we have to redesign the economy to facilitate resource sharing across the generational divides."

Ultimately, that's the difference between managing the coming demographic upheaval and suffering an actual earthquake. We already know roughly when the upheaval will hit and how hard. The extent of the damage, then, depends upon how well governments and corporations throughout the industrialized world prepare. And how soon. F

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